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Committee on Ways and Means
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Hearing on Transfer Pricing Issues
Submission for the Record

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The arm's length standard for transfer pricing is used throughout the world pursuant to OECD Transfer Pricing Guidelines (released 1995 and revised 2010) and section 482 of the U.S. tax code (statutory language regarding clear reflection of income implemented by applying the arm's length standard -- 482 regulations).

Arm's length transfer pricing works in the sense that there is a global standard and that neither governments, interested in revenue, nor taxpayers, interested in avoiding double taxation, are urging its replacement.

Appropriate U.S. Concern

However, it is appropriate for Congress to look at how section 482 is working in practice to ensure "that income properly attributable to the United States is not shifted to a foreign controlled party through inappropriate pricing of related party transactions." (Joint Committee staff document, JCX-37-10, July 20, 2010, page 5, second paragraph)

There is inappropriate shifting in one area, in this writer's opinion (as he has previously noted; "Territoriality for U.S. Corporations Getting Closer, but Important Issues Remain," Tax Notes Int'l, April 25, 2005, p. 311 at p. 313). That inappropriate shifting of income properly attributable to the United States results from a defect in section 482's second sentence.

The problem is that valuable property (usually intangible property) and functions can be originated in the U.S. by one or more members of a U.S. multinational group, transferred to one or more foreign affiliates of the group, and then transferred back to the U.S. (to related or unrelated persons) without reflecting all the income on the tax books of the U.S. group as the income is realized. Some taxpayers apparently treat those arrangements as separate 482 transfers to be valued in the year of transfer under the arm's length standard. That usually results in low 482 valuations. However, from beginning to end the arrangements are circular. Protection of the interests of the United States is better served by requiring that all the income be allocated to the U.S. as the income is realized. The second sentence of section 482 does not unambiguously do that.

Accordingly, the second sentence of section 482 should be redrafted to make clear that circular arrangements starting in the U.S. and coming back to the U.S. do not clearly reflect income unless all the income is allocated to the U.S. as and when the income is realized. Enacting legislation could provide that the new rule applies to all circular U.S.-to-U.S. arrangements, past and future, with appropriate offset for income previously reported on past transactions. A suggested redraft is as follows.

> *Section 482--current*
>
> ... In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.
>
> *Section 482--suggested revision to replace current*
>
> ... Where any kind of property, service, or function is transferred outside the United States and is subsequently used in or otherwise economically exploited within the United States, income shall be clearly reflected only if all income attributable to the transferred property, service, or function is allocated to the appropriate organizations, trades or businesses within the United States as such income arises.

With the transfer pricing interests of the United States protected, the way is open to move to a territorial system for U.S. multinationals.

Territoriality and a Competitive U.S. Corporate Tax Burden

Multinational corporations are the principal drivers of economic growth and prosperity. They require sound government policies within which to operate, but beyond good public policies national and international growth and prosperity result from the private sector led by multinationals.

There is no significant debate regarding those points among the major governments of the world, with the possible exception of the United States over the past eighteen months. Hopefully, debate in the United States is ending in favor of adopting the international consensus.

To survive and prosper multinational corporations must be competitive both inside and outside their home countries. For the U.S. to prosper, U.S. public policies, particularly tax policy, must allow U.S. multinationals to be competitive outside the U.S. and must provide that the U.S. itself is a competitive location for investment by both U.S. and foreign multinationals. [1]

Drafting good legislation is the first but not the last step to put territoriality into effect. Because territoriality should be optional, similar to filing consolidated returns, proposed and final regulations will be required. There should be full opportunity for Congressional review as well as for public comment. Territoriality should be limited to publicly traded companies to foreclose accumulation of cash and securities beyond active business needs and to give U.S. individuals direct and indirect investment opportunities in the electing multinationals.

A draft territoriality statute follows as an appendix. Under that draft there are no subpart F rules and no foreign tax credits. Tax items such as expenses, losses, deductions and credits are allocated to income from sources within and without the United States under the standard of clear reflection of income. Published financial statements should use the same standard.

In the absence of subpart F, the rules for interest deductions should be tightened. The U.S. tax base would be improperly reduced if a U.S. multinational could contribute cash (tax free) to the equity of a related foreign affiliate and then borrow the money back from the affiliate, even if the interest rate was arm's length. A suggested statutory amendment -- worthy of consideration even without territorial legislation -- is as follows.

> Section 163(x) DENIAL OF INTEREST DEDUCTION. -- Except as otherwise provided in section 163(j) or by regulations issued pursuant to this section, no interest deduction shall be permitted on any interest-bearing obligation between a U.S. corporation as debtor and a foreign affiliated or related corporation as creditor.

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[1] The income tax rate for corporations should be integrated with the individual tax rate on cash dividends and on stock sale gains, so that one-half the cash dividend rate plus one-half the stock sale gain rate plus the corporate rate does not exceed the highest regular individual income tax rate.

Thank you for your time in considering this submission.

Cornelius C Shields

Appendix: Tax Legislation Providing Elective Territoriality for Publicly Traded Corporations

Section 941 Election by qualified U.S. corporations to be taxed on a territorial basis
Section 942 Headquarters and holding subsidiaries of foreign parent corporations

SECTION 941. ELECTION BY QUALIFIED U.S. CORPORATION TO BE TAXED ON A TERRITORIAL BASIS

(a) ELECTION BY QUALIFIED U.S. CORPORATION. -- A qualified U.S. corporation may, under regulations prescribed by the Secretary pursuant to subsection (i) of this section, elect to be taxed on a territorial basis.

(b) APPLICATION TO SUBSIDIARIES. -- The election shall apply to the qualified U.S. corporation and to all U.S. corporations controlled directly or indirectly by it (together "electing U.S. corporation").

(c) PERIOD OF ELECTION. -- The election shall begin on the first day of the first tax year of the qualified U.S. corporation that is not less than 30 days (or such longer period as shall be specified pursuant to action taken under subsection (i)) after the date of the election and shall continue until

(1) the last day of the tax year of the qualified U.S. corporation in which an election revocation request is approved by the Commissioner (or such earlier or later date as the Commissioner and the qualified U.S. corporation may agree to), or, if earlier,

(2) the date specified by the Commissioner after the Commissioner shall have determined that the qualified U.S. corporation is no longer a qualified U.S. corporation, or

(3) the date specified by the Commissioner pursuant to subsection (j) of this section.

(d) TERRITORIAL BASIS OF TAXATION. -- Electing U.S. corporations shall not be taxed on their income from sources without the United States. Tax items (including expenses, losses, deductions and credits) that should be allocated to income from sources without the United States in order clearly to reflect income from sources within and without the United States, shall be allocated to income from sources without the United States.

(e) INTEREST DEDUCTIONS. -- Except as provided in regulations issued pursuant to this section, no interest deduction shall be permitted on any interest-bearing obligation between an electing U.S. corporation as debtor and a foreign affiliate as creditor.

(f) HEADQUARTERS AND HOLDING SUBSIDIARIES FOR FOREIGN OPERATIONS. -- Wholly owned subsidiaries (whether domestic or foreign corporations) of electing U.S. corporations shall not be treated as having income from sources within the United States by reason of

(1) having or maintaining within the United States an office or similar place of business, together with employees and associated property and equipment, and,

(2) in connection with such office, furnishing equity capital and other financing to foreign affiliates, exercising management supervision and control with respect to foreign affiliates, and supplying services to foreign affiliates that are incident to furnishing equity capital and other financing and exercising management supervision and control;

provided that tax items (including expenses, losses, deductions and credits) of such subsidiaries that should be allocated to sources without the United States in order clearly to reflect income from sources within and without the United States shall be allocated to sources without the United States.

(g) TAX RETURNS. --

(1) Tax Returns of Electing U.S. Corporations. -- Tax returns of electing U.S. corporations (including consolidated returns) shall include such schedules and statements as may be necessary and appropriate to set forth and explain, fully and fairly, differences between (1) tax and book income, (2) tax and book assets and liabilities, and (3) return on tax and book assets situate within the United States and return on tax and book assets of the electing U.S. corporations and all affiliates situate without the United States.

(2) Tax Returns of Subsection (f) Foreign Subsidiaries. -- Tax returns of foreign corporation subsidiaries claiming benefit under subsection (f), including such information returns as shall be specified pursuant to action taken under subsection (i), shall include such schedules and statements as may be necessary or appropriate to establish that the requirements of subsection (f) have been satisfied.

(h) DEFINITIONS. --

(1) U.S. Corporation. -- "U.S. corporation" means a domestic corporation within the meaning of section 7701 (a) (3) and (4).

(2) Qualified U.S. Corporation. -- "Qualified U.S. corporation" means a U.S. corporation a sufficiently substantial percentage of whose stock (not counting shares closely held by an individual or family) is traded on an established securities market that it is unlikely that the corporation is or will become a vehicle for individual or family portfolio investment. The Secretary or his delegate may, from time to time, publish the names of corporations he has determined to be qualified U.S. corporations.

(3) Controlled U.S. Corporations. -- A U.S. corporation is "controlled" if one or more U.S. corporations own stock in such U.S. corporation that together satisfies the 80-percent voting and value test of section 1504 (a) (2).

(i) REGULATIONS, NOTICES, AND OTHER ANNOUNCEMENTS. -- The Secretary or his delegate shall prescribe such regulations, notices, and other announcements as he may deem necessary or appropriate to carry out the purposes of this section, including the initial regulation and the initial approvable regulation.

(1) The initial regulation shall first be issued as a sufficiently complete proposed regulation, and after comments shall be issued as a sufficiently complete initial approvable regulation.

(2) The initial approvable regulation shall be issued as a final regulation pursuant to which elections may be made under subsection (a) only after approving legislation mentioning such regulation shall have become law.

(3) Subsequent regulations, notices, and other announcements shall be issued in regular fashion without the need for approving legislation.

(j) FAILURE TO COMPLY. -- Failure to comply with the provisions of this section (including regulations, notices, and other announcements prescribed by the Secretary or his delegate pursuant to subsection (i)) shall, at the discretion of the Commissioner, which shall be reasonably exercised, result in revocation of the election provided in subsection (a), or, if mutually agreed by the Commissioner and the qualified U.S. corporation, an appropriate lesser sanction, which may include monetary payment to the U.S. Treasury.

SECTION 942. HEADQUARTERS AND HOLDING SUBSIDIARIES OF FOREIGN PARENT CORPORATIONS

(a) HEADQUARTERS AND HOLDING SUBSIDIARIES OF FOREIGN PARENT CORPORATIONS. -- Directly and indirectly owned subsidiaries (whether foreign or domestic corporations) of foreign parent corporations shall, under regulations prescribed by the Secretary or his delegate, not be treated as having income from sources within the United States (or as having income effectively connected with or attributable to the conduct of a trade or business or a permanent establishment situate within the United States) by reason of

(1) having or maintaining within the United States an office or similar place of business, together with employees and associated property and equipment, and,

(2) in connection with such office, furnishing equity capital and other financing to foreign affiliates, exercising management supervision and control with respect to foreign affiliates, and supplying services to foreign affiliates that are incident to furnishing equity capital and other financing and exercising management supervision and control;

<u>provided</u> that tax items (including expenses, losses, deductions and credits) of such subsidiaries that should be allocated to income from sources without the United States in order clearly to reflect income from sources within and without the United States shall be allocated to income from sources without the United States.

(b) TAX RETURNS. -- A corporation may claim benefit under this section only if it files with the Commissioner an information return for the year and such other return as shall be appropriate considering the corporation's other activities and items of income. The return shall include such schedules and statements as may be necessary or appropriate to establish that the requirements of subsection (a) have been satisfied.

(c) REGULATIONS, NOTICES, AND OTHER ANNOUNCEMENTS. -- The Secretary or his delegate shall prescribe such regulations, notices, and other announcements, as he may deem necessary or appropriate to carry out the purposes of this section.
(d) FAILURE TO COMPLY. -- Failure to comply with the provisions of this section (including regulations, notices, and other announcements prescribed by the Secretary or his delegate pursuant to subsection (c)) shall, at the discretion of the Commissioner, which shall be reasonably exercised, result in denial of the benefit of this section for the year of failure to comply and all subsequent years, or, if mutually agreed by the Commissioner and the foreign parent subsidiary, an appropriate lesser sanction, which may include monetary payment to the U.S. Treasury.

SUPPLEMENTAL SHEET WITH NAME, ADDRESS, AND TELEPHONE OF SUBMITTER, CORNELIUS C SHIELDS, FOLLOWS

SUPPLEMENTAL SHEET

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